China Clarifies Issues on Foreign Tax Credit

[12 February, 2010 Issues 1]

China's Ministry of Finance and State Administration of Taxation jointly issued Circular Caishui (2009) No. 125 (Circular 125) on 25th December 2009, providing guidelines for claiming foreign tax credit (FTC) by China resident companies (CRC) and the establishment of non-resident companies (NRC) in China. Circular 125 was retroactively effective from 1st January 2008.

Following the issuance of the new China Corporate Income Tax (CIT) Law, Circular 125 clarifies a few issues related to FTC, such as scope, recognition and calculation of FTC. Circular 125 would be highlighted as follows:

Who may claim for FTC

In accordance with CIT law and its implementation rules, a CRC is subject to CIT on its income within and outside China. A CRC may claim FTC for foreign income tax paid on its taxable income sourced from outside China.

An NRC is subject to CIT on its income sourced from China. If an NRC has an establishment or place of business in China, the NRC is subject to CIT on its income sourced from China and overseas that is effectively connected to the establishment or place of business in China, for which an NRC may claim FTC.

However, if the companies are unable to accurately calculate the FTC amount in a particular country, no FTC would be provided for the income taxes paid in that country.

Recognition of foreign-sourced incomes

- The operating income and the corresponding expenses of a foreign branch of a CRC should be calculated in accordance with CIT Law and its implementation rules to arrive at the taxable income for FTC calculation purpose.
- The foreign-sourced income of the foreign branch of a CRC should be combined with the taxable income of the CRC for the current year, regardless of whether the income is actually repatriated back to China.
- The passive incomes such as dividends, interest, royalties, rental incomes and capital gains, and the corresponding deductible expenses should be calculated and recognized in accordance with CIT Law and its implementation rules.
- In case expenses are related to both China-sourced and foreign-sourced incomes, such expenses should be allocated between China-sourced incomes and foreign-sourced incomes (separately for each country) in a reasonable way.
- The losses of a branch of a CRC in a foreign country can only be used to offset against the income from the same country in the current year and may be carried forward for five years, and cannot offset against income derived from China or from other foreign countries.

Creditable foreign taxes

Creditable foreign taxes must be the taxes on income sourced from outside China, and taxable in accordance with the tax laws and regulations of the foreign countries, which have actually been paid in the foreign countries, and should be in the nature of a CIT.

Creditable foreign taxes do not include:

- Foreign income tax wrongly paid or collected under foreign income tax laws and regulations;
- Foreign income taxes that should not be paid pursuant to a double tax treaty;
- Interest, late payment surcharges, and penalties due to underpayment or late payment of taxes in foreign courtiers;
- Foreign income tax refunds or compensation actually received by the foreign income taxpayer or its related parties from the foreign tax authorities;
- Foreign income tax on income that is exempted from China CIT under the CIT law and its implementation rules;
- Foreign income tax that have been deducted from foreign-sourced taxable income pursuant to relevant regulations from the finance or tax authorities under the State Council.

Indirect FTC

The income earned by an overseas subsidiary of a CRC is normally not taxable in China until the profits of the subsidiary are distributed to the CRC. Upon dividend distribution, the CRC may claim FTC for the income tax paid by the subsidiary and attributable to the dividends received by the CRC. A CRC directly or indirectly holding at least 20% of the equity interest of an overseas subsidiary is qualified for applying for the indirect FTC.

According to Circular 125, an indirect FTC is limited to three tiers of overseas subsidiaries:

- For a first-tier foreign subsidiary, the CRC must directly hold at least 20% equity interest of the subsidiary.
- For a second-tier foreign subsidiary, a single first-tier subsidiary must directly hold at least 20% of the second-tier subsidiary, and the CRC must directly or indirectly hold at least 20% of the second-tier subsidiary.
- For a third-tier foreign subsidiary, a single second-tier subsidiary must directly hold at least 20% of the third-tier subsidiary, and the CRC must directly or indirectly hold at least 20% of the third-tier subsidiary.

Foreign tax paid and attributable to the dividend received by a CRC should be calculated from the lowest tier of qualified foreign subsidiary. The following formula is used to calculate the indirect foreign tax paid:

Foreign tax paid by the foreign company in the current tier but attributable to dividends received by the tier above = (Foreign tax paid on profits and gain from equity investment in this tier + Foreign tax paid by the foreign company of the tier(s) below, but attributable to the dividend income received by the current tier) x Dividends repatriated to the above tier / After tax profit in this tier

FTC Limitation and Calculation

Circular 125 reiterates that foreign-sourced income, FTC, and FTC limitation shall be calculated on a per country basis rather than on the basis of category of income.

FTC limit for a particular country (region) = Total tax payable on income sourced within and outside China according to CIT Law and its implementation rules x Taxable income sourced from a particular country (region) / Total taxable income sourced within and outside China

The tax rate used in the above calculation of the total tax payable on income sourced within and outside of China is 25% unless otherwise specified by the government authorities. If the total taxable income sourced within and outside China is less than zero, both the total taxable income sourced within/outside China and FTC limit should be treated as zero.

For a particular country (region), if the foreign income tax available for credit in accordance with Circular 125 is less than the FTC limit, the amount of tax payable in the foreign country is taken as FTC. Otherwise, the amount of the FTC limit would be taken as FTC, and the balance can be carried forward for five years.

In case a CRC obtains income from a country (region) which has double tax treaty (agreement) with China, and the foreign income tax related to such income has been exempted or reduced based on the foreign tax laws and regulations, while the amount of tax reduced/exempted should be treated as tax paid hence creditable based on the treaty (agreement), such tax reduced/exempted should be taken as foreign tax paid for FTC calculation purpose.

Simplified FTC calculation methods

(1) Under the following situations, a CRC can adopt a simplified method to claim 12.5% of taxable income sourced from a foreign country as FTC upon approval of the competent tax authority.

- For foreign-sourced operating profits or dividends which meet indirect FTC requirements, the taxpayer can present evidence issued by the foreign tax authority for the payment of tax; however, the amount of tax paid cannot be accurately identified due to objective reasons.
- The effective tax rate of the country where the income is sourced from is no less than 12.5%.

(2)Circular 125 has identified some countries whose statutory tax rate is obviously higher than that of China. These countries include Argentina, Bangladesh, Burundi, Cameroon, Cuba, France, Japan, Jordan, Kuwait, Laos, Morocco, Pakistan, Syria, the United States, and Zambia. For foreign-sourced operating profits or dividends which meet indirect FTC requirements, and which are derived from the above countries, the following formula can be used to calculate FTC:

FTC = Taxable income sourced from foreign country (region) x 25%

Under the simplified methods, foreign income tax not available for credit in the current year cannot be carried forward.

LehmanBrown Observations

Circular 125 provides detailed guidelines on recognition and calculation of FTC, which is a big step forward. However, there are still some issues to be clarified when claiming for FTC, for example, how could the operating income and the corresponding expenses of a foreign branch of a CRC be calculated in accordance with CIT Law and its implementation rules? In case of indirect FTC, how could the income source country be determined if different countries are involved in tiers of holding? We expect China authorities to issue more detailed guidelines to further clarify the related issues in the future, and we will keep you updated for any progress.